

DOW THEORY LETTERS INC.

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Letter 617

Nov. 29, DJIA 618.66; PTI 176; A-D ratio -33.87

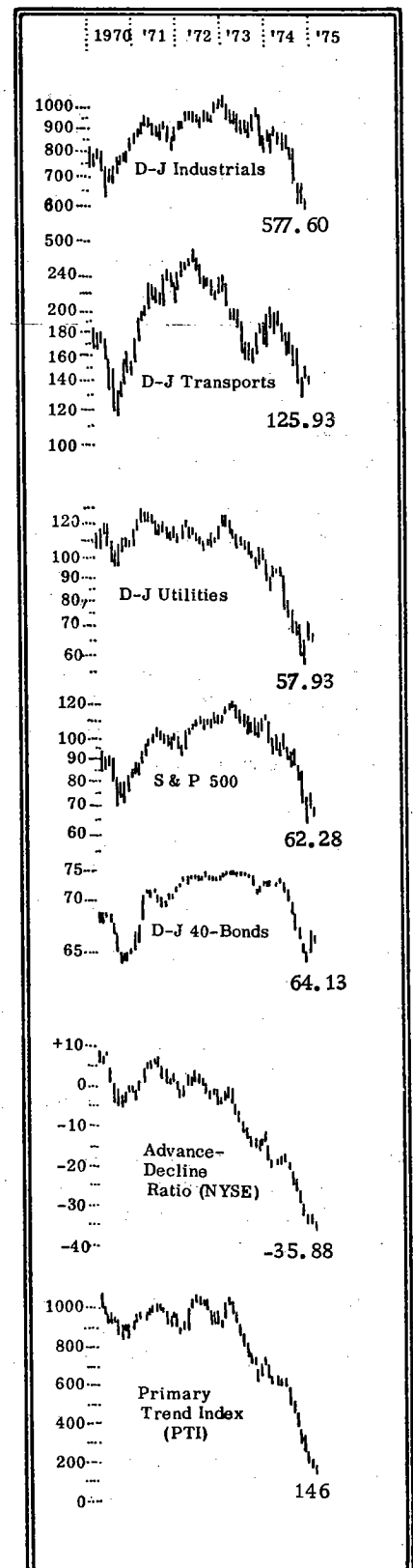
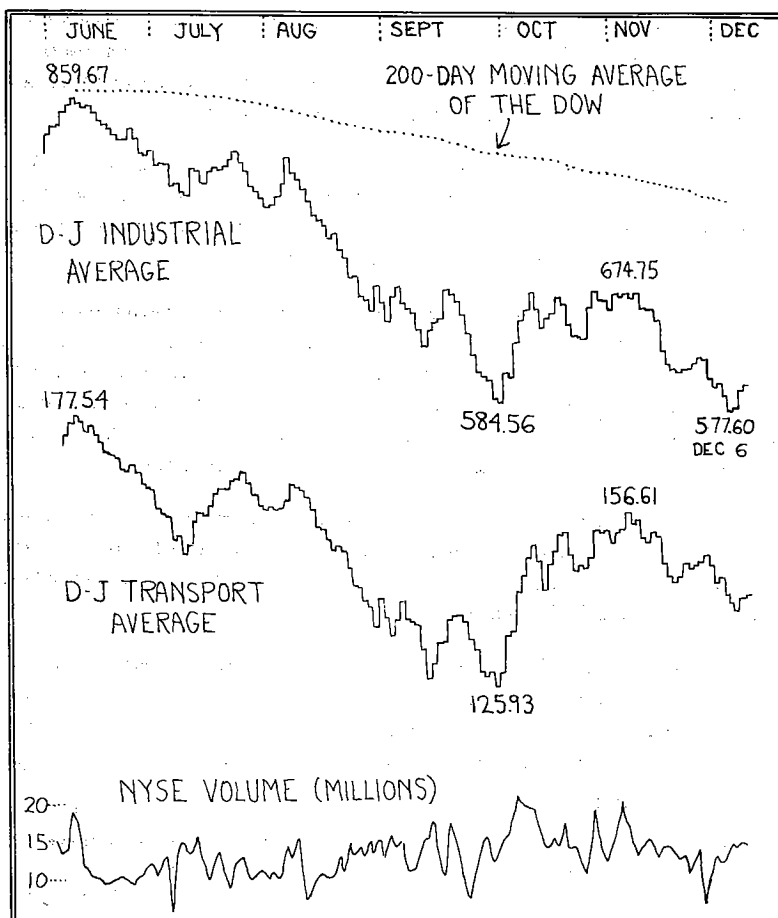
Dec. 6, DJIA 577.80; PTI 146; A-D ratio - 35.72

"On a surface level, life is a comedy; on a deep level, life is a tragedy." RR

THE MARKET: Decembers tend to be better months than most. If you had bought stocks on December 1 and sold them on December 31 during each of the 77 years since 1897, you would have made profits 73% of the time. Furthermore, the odds for a decent December increase when you have a poor year with a market low around October or November (as we did this year when the Dow hit an October low of 584.56). But it should also be noted that when the market doesn't do what it is "supposed to do," it is telling us something loud and clear. And that, it seems, is what is happening with the market now.

Study the long chart of the major bear market lows (seven averages and indices) as shown on this page. On the week ending December 6, three of the seven smashed to new bear market lows. On December 3 my Primary Trend Index (PTI), which is an amalgum of eight critical components, broke to a new low for the entire bear market. On December 5th the advance-decline ratio broke to a fresh bear market low, its lowest level since the mid-1940's. On December 6 (Friday) the Dow Industrial Average plunged through its October 4 low of 584.56, thereby adding fresh blood to one of the grimmest bear markets in the history of Wall Street.

When the market (or the Dow) records a bear market low as it did on October 4, there is always the hope that at that point the market has discounted the very worst that can be seen ahead. That, at least, is the hope. But when weeks or months later that low is pen-

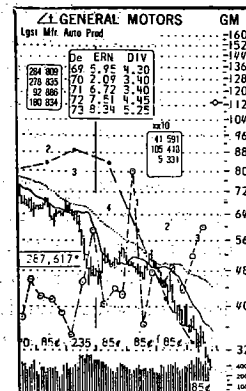


Page 2 etrated (as it was on December 6), Wall Street is telling us that the scenario is going to be darker than anything which could be envisioned at the earlier low. And that, I'm afraid, is the meaning of the December 6 penetration, at which time the Dow broke to its lowest level in twelve years. It was the market's way of saying, "Forget what the economists are forecasting, reset all the econometric models, erase from your mind any notions of what the market was telling you a few months ago, it's going to get worse, business is headed lower, the nation is heading for a bigger mess than anything we've planned on so far."

I've written before that a great primary bear market is a tragedy. It's a bringing down of the economic curtain on what went before. This nation has been enjoying the biggest and longest party (all on credit) in financial annals, and now the storm clouds are starting to break. I personally never wanted a party this big, and I certainly didn't want to see this variety of storm cloud. But my job is to report on the weather, and the forecast is "rain, low temperatures, and perhaps hurricane-force winds."

In my opinion, we are now seeing real third phase liquidating action in the market, the kind of action I have been warning about for months. We are witnessing the low volume and the relentless downward pressure that says, "Sell it, sell it at the market, don't tell me about the low price/earnings ratios, don't tell me about the high yields, don't tell me it was five times today's bargain price only a year ago; I need the cash, SELL IT!"

That's third phase action, and perhaps it can best be seen in the greatest manufacturing equity of them all, General Motors. GM is a stock with 287 million shares outstanding, a stock which is down 74% from its 1965 bull market high of 113. Despite this loss of \$21 billion in market value, GM continues to sink below 30, below 29, eighth by eighth, quarter by quarter. The accompanying chart (Chart courtesy of Quote, P O Box 213, Wichita, KS 67201) tells the grim story better than any words can. It's a story of selling under pressure and fear, moving the shares out by the thousands and hundreds of thousands — to raise hard cash.



Great bear markets feed on massive liquidation of debt and the slashing away of inefficiencies and profitless operations, a "melting of the fat." Great bull markets develop in those mysterious areas of rising liquidity, zero speculation, low exchange volume and depressed public sentiment. But always, at the bear market bottom, there is a build-up of cash brought on by fears of the bear.

When a man is frightened, he moves to get liquid. He forgets his plan to buy the new TV set, he eats at home instead of the new downtown French restaurant, and he puts his money in the savings account instead of haunting the loan window of the local bank. When the members of a corporate board become frightened, they are very apt to act the same way. They cancel capital spending plans, they cut salaries, they trim down employment lists, they cart out the hot-cold water fountain, they try to build up liquidity.

At today's juncture in the bear market, it is clear that individuals and corporations are at least "trying" to move towards the liquidity gates. Consumer credit registered its smallest rise in four years last month, but note — it was still expanding. Corporations are trying to trim their expenses now, but note that labor costs are still rising. And our Government is making no headway at all in really cutting expenses. The coming deficits, for this reason (and reasons of a tax shortfall) are fated to be astronomical.

Ultimately, this period will come to an end. As the fabled Zen monk put it, "this too shall pass away." As I see it, the bear market will end in one of two ways. The first possibility would come following a period of true third phase liquidation, a period in which cash holdings have expanded greatly, the debt structure has deflated very substantially, prices and wages have come down, and consumer demand has built up. This kind of action would lay the base for an extended, primary bull market.

The second possibility is that this bear market will end in perhaps the Dow 475 to 525 area, amid obvious Government moves towards sky-rocketing spending and renewed inflation (I should say hyper-inflation). If the bear ends that way, the new bull market would almost surely not be an extended one (it would last maybe a year or so), nor would it be guaranteed to take the Dow and most stocks over or even near their old highs. Nevertheless, we could have a period in which many thoroughly depressed issues (and hundreds of them are now down 70% to 90% from their highs) would double, triple and quadruple. Remember, if a stock drops from 80 to 5, it has lost 93.7% of its value. But if it then rallies back to 30, those who bought it at the low of 5 have made a 500% profit.

I want to mention a few points that have been bothering me. One is that a few really outstanding analysts have come out strongly for the second scenario, that is, a drop to around Dow 520, and then a new bull market (or at least a major bullish advance into 1975-76). When you think about it, that's actually a very bullish concept at this point. It means that we're now within 50 points or less than 10% from the projected bottom. On that basis, we should really be accumulating stocks now.

Could that be the case, or is the market going to cross even the "moderate bears" and go much lower than now seems reasonable or probable? Once again, I'll repeat my old adage that "The market always does what it has to — to drive the most number of people crazy." Therefore, I am at least prepared for the Dow to stop well short of 520 — or to go considerably lower. So let's let Wall Street do the talking from here on. We're in the third phase of a great bear market, and I'll stick to Robert Rhea's thesis that neither the extent nor the duration of a primary movement can be determined in advance.

Here's a second point which has bothered me. A great deal is being made of the Utility Average as a barometer or lead indicator of the market. I have used the Utilities for years as a lead Average, but if you think this is an infallible concept, forget it. For instance,

Utilities hit a bear market low in February, 1948, at 31.65. That final low occurred sixteen months ahead of the final Dow low of 161.60, recorded in June, 1949! Sixteen months is a long time.

The Dow Utilities hit a low of 57.93 on September 13, 1974. This has been widely proclaimed as a bullish phenomenon of great significance. And it is bullish if Utilities hold, but suppose we were to follow the example of 1948-49? If we were to follow that script exactly, the Dow Industrials would hit its final bottom in March, 1976, 16 months from September, 1974. So the Utility low of September, 1974 is a hopeful indication — nothing more.

A third unpleasant or should I say ominous observation! I am including a chart of the Dow and the ratio of bullish and bearish investment services. Note that at each Dow rally peak, the sentiment index has moved over 1.0 or well into the bullish-ratio territory. This suggests that the majority of investment services are ready to take every rally as the start of something "big," hopefully a new bull market. When the real bear market bottom arrives, I would guess that the first primary bull rally will be greeted with a great deal of skepticism, unlike the bulge in bullish sentiment that we have seen so far when the market pushes up. I have labeled the four rallies in the market and in bullish sentiment with a sequence of 1 through 4 on the chart. The latest jump towards bullish sentiment occurred in November (4), with the Dow at about 670. (Chart courtesy of Merrill Analysis, Box 228, Chappaqua, NY 10514).

THE PICTURE: Time magazine's December 9 cover shows a bedraggled Santa dragging an empty gift sack, all under a large caption which reads, "Recession's Greetings."

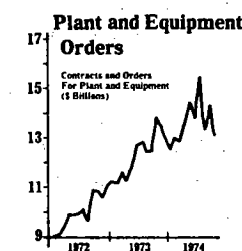
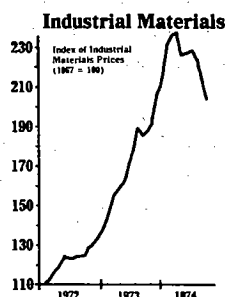
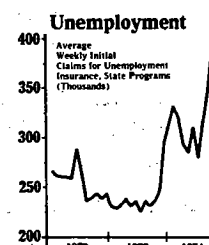
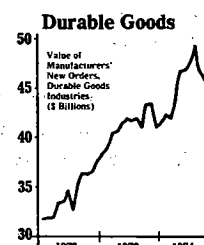
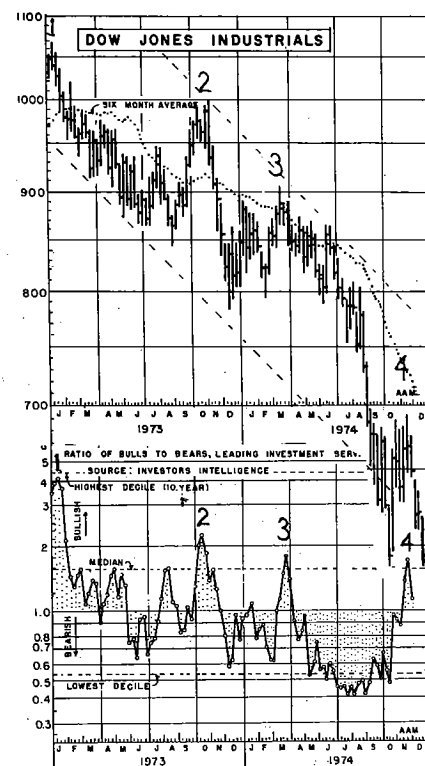
Newsweek (Dec. 9), in a cover story on President Ford, wonders whether Mr. Ford knows what's going on and "whether Ford has the will to exercise power". House Ways and Means Chairman Wilbur Mills tumbled from power last week in a tragi-schizophrenic flight from sanity via a tryst with a stripteaser. The same week Treasury Secretary Simon announced that the US would auction (not sell at the market, mind you, but "auction") 2 million ounces of gold. This was supposed to supply the gold market with fuel, in preparation for January 1, our "legal gold day". On December 5 Federal Reserve Chairman Burns came out against US legalization of gold at this time. Burns said, "Speculative forces originating in gold may spread to other markets" Burns said nothing about the speculative forces of an ever-expanding US money supply.

While these exotic events were transpiring, US coal miners signed a contract that would ultimately give them a 63% boost in pay. And in the face of a crushing auto slump, Detroit (which up to now has been called the "murder capital of the world") inherited a new name, "Ghost City, USA". The tax which Mr. Ford was going to render unto America has suddenly been forgotten. Amid fading inflation and rising unemployment (see charts from **Financial Weekly**), Administration economist Alan Greenspan is now talking about a tax cut. At the same time, commodity markets are caving in, industrial material prices are slumping (down 20% from the year's high), and it would not surprise me to hear politicians talking about plans to prop up prices as we move into 1975.

Like all primary movements, this bear market has assumed international importance, with the slump enveloping nation after nation. Even Switzerland, bastion of sound currency, is now suffering a housing slump, while West Germany, the Free World's strongest economy, is now seeing real unemployment for the first time in the memory of the Post-Hitler generation. Material received here allows me to monitor world markets and economies with a scope far beyond the means of most offices. For instance, **Capital International Perspective**, 15, rue du Cendrier, 1201, Geneva, Switz., provides market and economic charts for 15 major industrial nations. Of the 15, only Switzerland and Belgium show any upward progress in their rate of industrial production. All the other nations now suffer contracting economies.

According to the **International Bank Credit Analyst** (Monetary Res. Ltd., Butterfield Bldg., Front St., Hamilton, Bermuda), "In both a political and economic sense, the Western world is witnessing the breakdown of the institutional mechanisms that have always been relied upon to deal with crisis The IMF has become totally ineffective in dealing with adjustments between currencies and so it is largely ignored. ... The EEC is drifting into the same sort of oblivion."

All of this has been producing reaction of every variety. My mail brings me literature almost daily regarding the latest survival techniques: dried food, trench shovels, portable electric generating kits, the latest in pistols, and on and on. I sit and wonder, "Is America cracking up, coming apart at the seams, or is it simply twitching convulsively in a Herculean attempt to regain its sanity? Frankly, I can't decide."



Page 4 But here is one conclusion I have come to. I believe that President Ford is basically a conservative man. If nothing else, I believe he understands the meaning of inflation. Chief Economic Advisor Alan Greenspan also knows that inflation is the destroyer. The third member of the triumvirate is Treasury Secretary Simon. I feel that these three men want a real correction in the economy on the theory that a severe or prolonged recession will break the back of inflation.

Against them, we have a Democratic Congress, which is dedicated to (1) giving people what they want, (2) avoiding any pain and (3) willing anytime and always to accept inflation over unemployment. But it will take until January for Congress to get together (with its new members) and to start putting the pressure on to spend. By that time, much "correction" can be built into the 1975 and 1976 economy. Nevertheless, the market will be discounting the situation as far ahead as it can see — perhaps six months to a year.

The above is a rather abbreviated description of the big politico-economic struggle that I see going on and one that the market is attempting to appraise. Of course, there are always "the things that go wrong," that great army of accidents and unforeseen events. One such is Europe, where the Common Market Foreign Ministers have just met. Out of the meeting came nothing except words, dire predictions and a general agreement to "reflate". A second accident-prone area is Britain. As the London stock averages break to new low after new low, I ask myself, "What in the devil is the British market telling us? Down from the 1972 high of 543 to today's new low of 157! That's a loss of 71% overall. Is this the end of the British free enterprise system?

MOMENTUM: Throw a ball straight up in the air. First it rises rapidly, then the rate of ascent decreases. Finally, for just a fraction of a second, the ball suspends motionless in the air. At this point the upward momentum has touched zero. Then the ball begins to drop, picking up downside momentum as it falls.

What are we talking about as we describe the movement of the ball? We are describing the rate of change of its movement or its momentum. If we charted the upside momentum of the ball we would see that even as the ball

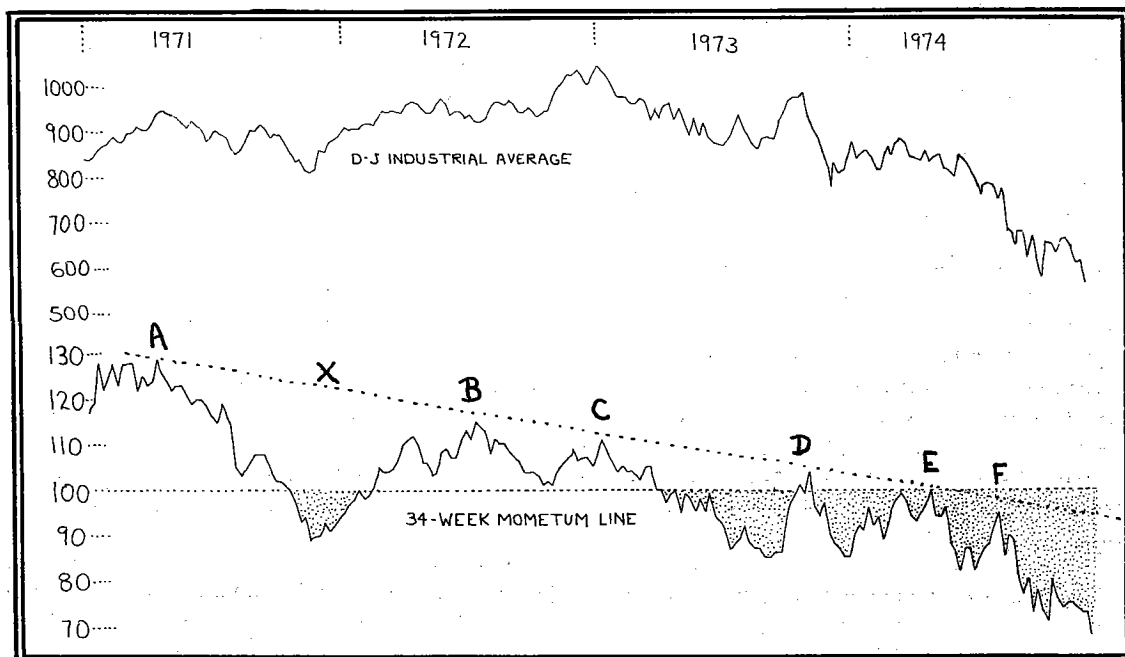
was rising its rate of ascent was declining. This action in momentum tells us that a change in the direction of the ball's movement is in the offing. This last phenomenon is exactly what we want to know when we use momentum studies in the stock market, namely, "When is a change of direction in price coming?"

In the previous Letter (616) I said that I was going to depend heavily on two technical studies to tell us when the tide was turning in this final or third phase of the primary bear market. One study would entail the use of the moving averages of the Dow, and the other study would concern itself with momentum.

Back in Letter 602 I presented my momentum chart of the Dow. At that time (July 5, 1974) I said that the Dow's upside momentum was running out and that the real downside momentum was about to take hold. During the three months following Letter 602 the Dow dropped over 200 points. The Dow was literally "falling back to earth".

I have included my long-term or 34-week momentum chart of the Dow with this report. This chart is constructed by dividing the current (weekly Friday closing) of the Dow by its Friday closing of 34 weeks ago. Why do I use 34 weeks instead of 30 or 14 or 5? (1) Because 34 weeks is a medium to long-term period (approximately 5 months), (2) because through trial and error I have found that a 34-week moving average gives very good results, and (3) because 34 is a Fibonacci number (so is 5, as in a 5-month period). Note: new subscribers may purchase Xerox copies of Letter 581, covering Fibonacci numbers if they send \$2 and a self-addressed envelope.

Now turn to the chart. Note that it covers all the action (weekly) from 1971 to date. Any time the Dow is above its price of 34 weeks ago, the momentum line will be above 100. Conversely, any time the Dow is below its price of 34 weeks ago, the momentum line will be below 100, and this area is shown as the shaded zone. But the really interesting fact that this chart points up is that the Dow has been losing momentum for four consecutive years on a trend basis, as denoted by the declining trendline marked X on the chart.



December 13, 1974

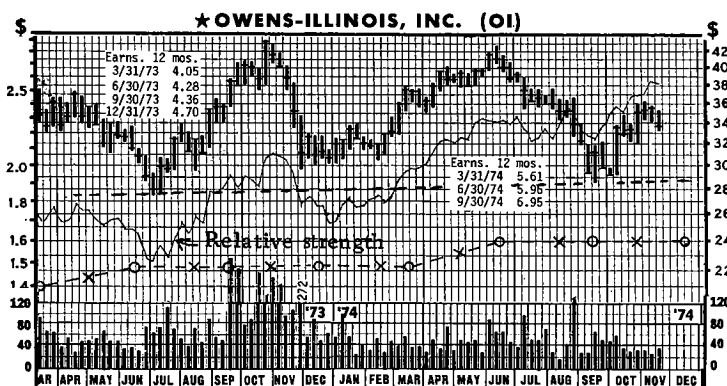
As a rule, the more times a trendline is approached or tested, the more important that trendline becomes. I believe it is particularly significant that the declining momentum trendline (X) was tested once in 1971 at point A, twice in 1972 at B and C, once in 1973 at point C, and twice in 1974 at E and F. Note that at F (July, 1974) the upward stab of the momentum line was so weak that it failed to make contact with trendline X. It was here that I wrote (Letter 602) that the Dow was ready "to collapse as the strength still residing in the Dow finally washes out on the downside". The subsequent 220 point drop in the Dow confirmed what the momentum chart was telling us.

The 34-week momentum line is now at 73, near its lowest level in years. It is well to remember that the Dow will continue to drop even if the momentum line moves sideways in the shaded area. But once the momentum line starts climbing up on a trend basis (even though still within the minus or shaded area) we will know that the rate of decline in the Dow is ebbing. Ultimately, the momentum line will push decisively above the declining trendline (X). When this occurs, we will have a very hopeful signal. It will imply that the downside momentum of the last four years is being reversed. Following this, when the momentum line pushes above 100 or out of the shaded area, we should have the development of a bullish situation. Such action will constitute one of the technical conditions we will need to confirm the existence of a new bull market.

I should add that I have records of momentum in the Dow from 1897 to 1935 and for the S & P 425 Industrials from 1935 to date (charts which were sent to me courtesy of Ray*Signals, 43 Lake Avenue, Montrose, PA 18801). The chart shows only four periods of declining momentum which compare in duration with the current period of 1971 to date. These four periods were 1901 to 1904 (three years of declining momentum), 1905 to 1908 (again three years), 1929 to 1932 (three-and-one-half years), and 1936 to 1942, an amazing six-and-one-half years. The current period has lasted three-and-one-half years so far. It therefore has become the second longest period of declining momentum in stock market history. (Note: the latest momentum figure of 68 is the lowest of the entire bear market.)

In the next report I will discuss another major technical criterion that we will be depending on to provide signs of THE bottom, and that is the moving averages of the Dow.

STOCKS: I spent the weekend going over my own relative strength charts and charts of the entire NYSE. There's no question about it, a few items are beginning to look interesting. The container (can and glass) group has been rising in relative strength since January 1974. Some of the stocks in the group may have bottomed out for the whole bear market. Continental Can, which topped out in the low 50's five years ago, is now in the low 20's. It made its low last December. Owens-Illinois (see chart), which hit a high of 81 in 1968, is now around 30. But it hit its low in July, 1973, and it has not been lower since. Union Carbide, another Dow stock (as is Owens-Illinois), looks good, and the fourth stock that I have been watching is United Aircraft (also a Dow stock). UA has been showing remarkable relative strength, and it too could have made its bear market low.



"Why not buy 'em here?" you ask. The answer is that jumping the gun and buying these four might work well. But it could also be a scary proposition if this bear market has say even one more brutal downward swing. For instance, the final primary leg down in the 1929-32 bear market took the Dow from a March, 1932 peak of 88.78 to a July, 1932, low of 41.22, a loss of 55.5%! And that all occurred in a period of four months.

Therefore, I would prefer waiting for definite indications that the bottom is either here — or that it has passed. The latter would, of course, mean paying more for the stocks we want but so what. That's the cost of insurance, and more often than not it is well worth paying. Remember, three in-and-out trades with a loss of 15% to 20% each, and you have lost half your trading capital. (OI Chart courtesy of Securities Research, 208 Newbury St., Boston MA 02116).

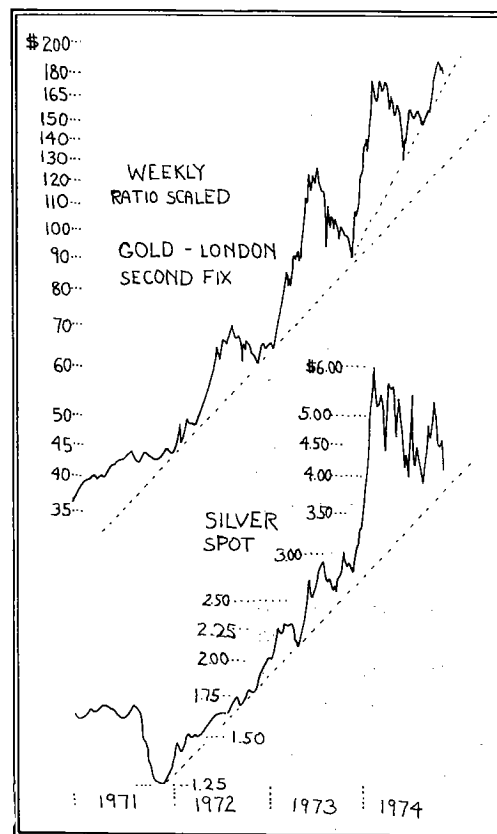
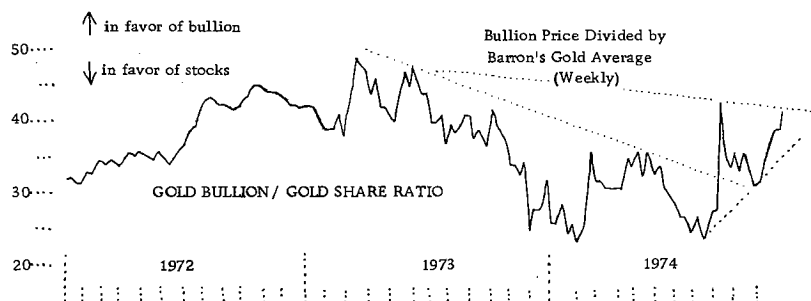
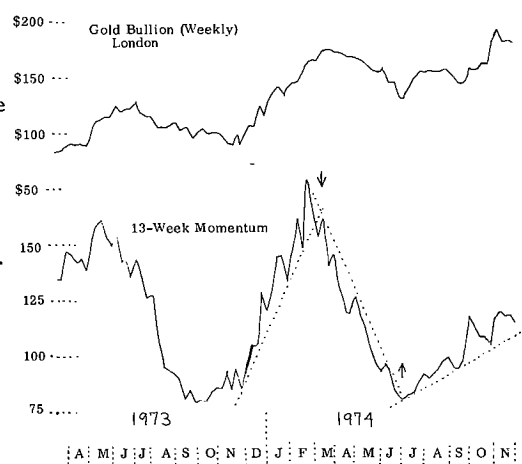
GOLD: Much ado about the US selling 2 million ounces of gold: My friend C. V. Myers believes the US is "testing" the gold market and at the same time actually testing the value of the dollar. Note that the gold is being sold in 400 oz. bricks, and it's therefore earmarked for big money test. If the US January gold goes at say \$175 or \$165 or \$180 for the whole 2 million ounce lot, well, that is saying something about the dollar and about the market. Myers believes this would establish a kind of convertibility.

Personally, I see the gold sale as simply more US "control-madness" nonsense. The implication (or at least the one desired) is that the US can knock down the price of gold anytime it wants. That's true in a weak market or a market where inflation is being cooled (as is the case now). But start the reflation machines, start the money supply booming, and no amount of US dumping (pardon me, "auctioning") will knock gold down. It'll be gobbled up like ice cream in July. So everything is a matter of timing.

My gold momentum (page 6) chart is still intact, with gold momentum climbing up a rather shallow rising trendline. Bullion would have to move into the 165-170 range to take the momentum under the trendline. From another viewpoint, gold and silver bullion continue to hold above their long-term trendlines as seen on the Page 6 ratio chart. At 171, gold will break below its secondary or

Page 6 steep rising trendline, but the long-term trendline coming up from the 1971 low will hold as long as gold is above 130. Silver, however, is getting close to trouble. At 3.75, silver will reverse its long-term trendline. If this occurs, I would say that we would have a definitive signal of deflation (indicating that silver was doing a swandive along with the rest of the commodities).

The gold bullion/gold share ratio is still climbing up the rising trendline in favor of gold over gold shares.



A higher trendline connecting the 1973 peak and the September, 1974 peak has just been touched. A further rise in the ratio would make it abundantly clear that the markets were opting for gold and gold coins over gold shares. This is a trend that I drew attention to months ago. As I've said many times, I don't make the markets, I just try to refrain from kidding myself and my subscribers about what's going on.

I am including my own daily ratio chart of ASA, and here we see typical listed (NYSE) gold action. First, we have the head-and-shoulders top in July-August, the smash into September, then the September-October rally, and a second head-and-shoulders top formed during October-November. Normal post-panic action would entail a testing of the 52-1/8 low of September, and this is what we may now be seeing. Technically, if that September low is penetrated, we would have a major A-B-C pattern in gold, that I think would end the gold correction. It is a nasty downmove, and this is the reason I have encouraged subscribers over the past few months to cut back substantially on gold positions (referring to gold shares, not coins).

In the meantime, today (December 10) the D-J Commodity Futures plunged below their major rising trendline (see Letter 615, page 3), thus knocking another brick out of the inflation edifice. I continue to think that deflation will be the word by early 1975, not inflation. Since much gold was purchased on the rationale of continuing inflation, this is bound to exert pressure on gold and gold shares (the real inflation, remember, comes later).

Yesterday, Saudi Arabia announced that it would accept no more British pounds. If they won't take more, will they keep what they have? Today, the pound broke to an all-time low along with the British stock market. Is Britain going under? If so, will "they" save it? West Germany just announced that it is running out of patience as far as supporting its partners. From our own selfish standpoint, it should be remembered that US banks are heavily involved in Britain, in amounts that are estimated to be well above \$5 billion. In other words, if Britain totters, put on your hard-hat. Will the US bail out Britain? I doubt it. From here on in this bear market's third phase, watch for the "accidents," the unforeseen mistakes. These are the things the economists never feed into their models, and these are things that provide the panics in the market.

